Moss Adams – Introduction to ESOPs

Looking for an exit strategy...Have you considered an ESOP?

Since 1984, we have performed over 2,000 Employee Stock Ownership Plan (ESOP) valuations for companies with as few as 20 employees and for those with well over 1,000 employees. Our ESOP valuations are primarily prepared for the purposes of establishing the value of stock to be acquired. We specialize in two types of ESOP valuations:

Initial ESOP transactions – we act as financial advisor to the trustee in performing our valuation analysis, we also can prepare the necessary documentation for closing the transaction such as a Bridge Letter and Fairness Opinion

Annual ESOP update valuations

What is an ESOP?

An Employee Stock Ownership Plan (ESOP) is a defined contribution employee benefit plan with its primary objective to provide broad stock ownership interest to employees. Several features make ESOPs unique compared to other benefit plans. First, only an ESOP is required by law to invest primarily in the securities of the sponsoring employer. Second, an ESOP is unique in its ability to borrow money. As a result, "leveraged ESOPs" are not only used to reward and motivate employees, but being able to reduce the sponsoring company’s taxable income by the interest and principal borrowed to buy shares owned by the ESOP can result in the ESOP being used as a tool of corporate finance.

ESOPs are most commonly used to provide an exit strategy for departing owners of successful privately-held companies, to motivate, retain and reward employees. In many cases, business owners want to reward the employee base who helped make the business a success. Business owners often have a desire to leave a legacy which is most often otherwise lost when a change in ownership occurs. ESOPs can also be used to take advantage of incentives to borrow money for acquiring new assets in pretax dollars. If any of these factors resonate, you may want to explore an ESOP.

A company which wants to set up an ESOP creates a trust to which it makes annual contributions. Shares sold by the owner are held in this trust for the benefit of the participants. Based on a number of different methods of allocating stock to employee accounts, these contributions are allocated to individual employee accounts within the trust. The most common allocation formula is in proportion to employee pay, but formulas allocating stock according to years of service, some combination of compensation and years of service, and equally, have all been used. The ESOP plan document defines who is eligible to participate in the ESOP. Generally, all full-time employees over 21 who meet a minimum number of hours of service participate in the plan.

As employees accumulate shares in their accounts, they usually do not have immediate access to the shares; the shares must also vest. Employees must be 100% vested within three to six years, depending on whether vesting is all at once (cliff vesting) or over a period of time. Some companies vest employees’ entire accounts immediately if they are eligible to participate in the plan.
How Does a Participant Receive the Benefit?

Employees receive the vested portion of their accounts at termination, disability, death, or retirement. This is often referred to as the participants’ “put option.” Proceeds from the sale of vested stock may be made in a lump sum or in installments over a period of years. If employees become disabled or die, they or their beneficiaries receive the proceeds of their ESOP accounts immediately.

When employees leave the company, they receive the vested stock of their accounts. If the company is publicly traded, the employee can sell his or her shares on the open market. However, the vast majority of ESOP companies are privately held which means there is no active public market for the shares. For privately held companies, the company or the trust must give the employees a right to sell his/her shares back to the company or trust (the “put option”) for 60 days after the distribution of shares. If the employee chooses not to sell at that time, the company must offer another put option for a second 60 day period starting one year after the distribution date. After this period the company has no further obligation to repurchase the shares. Private companies must have an annual outside valuation to determine the price of their shares. This put option creates a “repurchase obligation” for the company.

Once the shares are redeemed or repurchased, an ESOP company may make an "installment distribution," provided that it makes the payments in substantially equal amounts, and over a period to start within one year for a retirement distribution, within five years for a pre-retirement distribution, and not to exceed five years in duration in either case. The company must provide "adequate security" and pay interest to the participant on the unpaid balance of an installment distribution.

Participants do not pay tax on stock allocated to their ESOP accounts until they receive their distribution. Similar to other qualified retirement plans, if the ESOP participant is younger than age 59 1/2 (or age 55 if they have terminated employment), they are subject to applicable taxes plus an additional 10% excise tax unless they roll the money over into an IRA or a successor plan in another company (unless the participant terminated employment due to death or disability).

Are Participants' Shares Redeemed or Recycled?

Shares of terminated participants can be either redeemed by the company or purchased by the trust. If the trust buys the shares, they are reallocated among the remaining participants. This is often called “recycling” the shares. Redeemed shares typically go into treasury. If the ESOP is not the 100% owner of the company, redemption reduces the ESOPs ownership of the company. As shares are redeemed and go into treasury, the number of outstanding shares declines; over time this results in an increasing value per share all else being equal. There are a number of factors to consider in determining to redeem or recycle.

While not a requirement for establishing an ESOP, a plan for meeting the privately held company's repurchase obligation should be developed. The repurchase obligation and its growth over time may be affected by factors like the size of the annual ESOP contributions, the change in the value of shares between the dates of contribution and repurchase, the vesting and distribution provisions of the ESOP, and employee turnover.

There are a number of ways of planning for and meeting the repurchase obligation including making substantial cash contributions on an annual basis, and buying insurance to cover the plan's obligations. Cash contributions can be earmarked but remain on the company’s books or actually contributed to the ESOP; there are pros and cons to either route.
What Information are Participants Entitled to?

Since ESOPs are governed by ERISA, participants are entitled to the same information under ERISA as participants in any other retirement plan. Examples of information the participants can expect include: a summary plan description, an annual statement regarding the status of their account, a summary annual report, and other plan information, such as plan and trust documents, if they request it. Participants are not entitled to corporate financial statements, information regarding compensation, the valuation report, etc.

For private companies, participants are typically only allowed to vote allocated shares under a certain set of circumstances (the pass through vote). The trustee typically casts the vote for unallocated shares. The ESOP pass through vote is triggered in the event of significant corporate events such as merger, liquidation, recapitalization, sale of substantially all company assets (but not the stock unless it involves a merger), and dissolution. In public companies, employees must be able to vote all issues.

Diversification Rules

When an employee who has at least ten years of participation in the ESOP reaches age 55, he or she must be given the option of diversifying his/her ESOP account up to 25% of the value. This option continues until age 60, at which time the employee has a one-time option to diversify up to 50% of his or her account. This requirement is applicable to ESOP shares allocated to employee's accounts after December 31, 1986. There are also rules which guide the employer’s responsibility in offering investment alternatives to participants who elect to diversify their accounts.

Steps to Setting Up an ESOP

One of the great advantages of ESOPs is their tremendous flexibility. An interested party should talk to its professional advisors to tailor a plan that is best suited to its particular needs and goals. Once you have done some preliminary research and educated yourself on the topic, the following is a basic guideline summarizing the steps a company might take in designing and implementing its ESOP.

Perform a Feasibility Study

The extent of this analysis can vary, but there are several things the feasibility study will typically accomplish. As part of this initial feasibility, an estimate of value will have been calculated for privately held companies. Once the value of the company or size of the deal has been estimated, the first step is to consider whether or not the sponsoring company will have available cash flow to service the debt as a result of a leveraged transaction? Second, because there are limitations on how much a company can contribute annually, does the company have adequate payroll to make ESOP contributions tax deductible?

Conduct a Valuation

For privately held companies, the feasibility study will have relied on an estimated value of the company. A formal valuation will have to be conducted by an experienced appraiser. Once the value has been determined, the company will want to be sure the assumptions in the feasibility study are still reasonable and the value is acceptable to the parties of the proposed transaction.

It is important to remember who hires the appraiser. If the appraiser is hired by the trustee, he or she is the financial advisor to the trustee (the buyer) and has to be careful not to divulge information to other parties (i.e. the seller) which may be detrimental in the negotiating process.
Professional Advisors

ESOPs can be very flexible tools. Companies have created ESOPs as an employee retirement plan, for purposes of business continuity, financing, enhanced employee motivation or as a combination. An experienced ESOP attorney will be able to help you develop a plan that will best serve the company’s and the participants’ interests.

In addition to hiring an attorney, a trustee must be chosen to oversee the plan. In many private companies, this could be someone from inside the firm. Increasingly, plan sponsors are turning to professional trustees, such as a bank or trust company. The trustee is the person who has fiduciary responsibility for the plan and to its participants. The trustee typically hires the appraiser to act as his or her financial advisor.

The job of ESOP administration is also a function which may be given to a professional administration firm or handled by the sponsor. The administrator is responsible for maintaining the individual records of the plan in order to keep track of exactly who are the current participants in the plan, what percent is each participant vested, what is the content and value of each participant's account, etc.

For larger transactions, the seller will often have his or her own professional advisors including legal counsel just as there would be in a traditional merger or acquisition.

Implementing the ESOP

When the process of analyzing and designing the ESOP is complete, the formal plan document, which will explain the specific terms and features of the ESOP, will be prepared by an attorney. The plan document should include language addressing the plan's purpose and operation, eligibility requirements, participation requirements, company contributions, investment of plan assets, account allocation formulas, vesting and forfeitures, voting rights and fiduciary responsibilities, distribution rules and put options, employee disclosures, and provisions for plan amendments.

An appraiser will prepare a finished and formal evaluation report. Due to a time lag between the availability of financial statements and closing date, there is typically a gap between the date of value and closing date of the transaction. Obviously, this gap should be as small as possible. This report is then presented to the trustee. The trustee reviews and considers the valuation in his or her decision to execute the transaction, but the trustee is ultimately the fiduciary and negotiates the price.

In the case of leveraged ESOP transactions (borrowed funds are used to acquire stock), arrangements must be made for securing the financing needed to complete the transaction. Lending institutions are becoming increasingly familiar with how ESOP loans are structured. The lender may also be the seller (“seller financed”). Many transactions are a combination of bank and seller financing.

The company must formally adopt the plan and trust documents which establish the ESOP and the trust. Also, the company usually submits a copy of these documents to the Internal Revenue Service with an application for confirmation (called "determination") of the plan's tax-qualified status (Form 5300). The plan must be a qualified ESOP under sections 401 (a) and 4975 (e)(7) of the Internal Revenue Code in order to be eligible for the various tax benefits associated with ESOPs. It is not normally necessary, however, to wait for a letter of determination from the IRS to begin the plan.

Once a company adopts an ESOP, it can claim a deduction retroactive to the beginning of that fiscal year.
Are you a suitable candidate?

There are no hard and fast rules regarding a suitable candidate for an ESOP. The most common question has to do with size, profitability and “are we too small to have an ESOP?” To provide some feedback on this question, one has to consider the cost of implementing and maintaining an ESOP.

Depending on the size of the company, its complexity and the complexity of the ESOP the cost can vary tremendously. There are several components of cost: legal fees for the preparation of plan documents and government filings; obtaining a valuation; administration; and, in a leveraged ESOP, loan commitment fees, legal fees for the lender's counsel and loan documents, and, possibly, financial consulting for structuring the transaction. Once an ESOP is in place, ongoing costs typically involve administration; obtaining a valuation; and, trustee fees if an outside trustee oversees the plan.

While there can be a number of advisors involved and the process can be complicated, in our experience the cost of implementing an ESOP and executing a transaction is significantly less than a sale through an investment banker. A leveraged ESOP transaction will likely cost a minimum of $7,000.

In general, ESOPs do not work well for a company that either: (1) does not already have a competent management team, or (2) one that has been identified to lead the company once the seller leaves. The seller also typically wants to be employed by the company for a number of years once the ESOP is in place. During this period, the business succession to the management team is completed.

As a rule of thumb, you want to have an employee base of at least 20 and a transaction value of $1-$3 million.
**Why an ESOP Makes Sense**

**Buy the Shares of a Departing Owner**

Owners of privately held companies can use an ESOP to create a ready market for their shares. Under this approach, the company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares. In C corporations, once the ESOP owns 30% of all the shares in the company, the seller has the option to reinvest the proceeds of the sale in other securities and defer any tax on the gain.

**Borrow Money at a Lower After-Tax Cost**

ESOPs are unique among benefit plans in their ability to borrow money. The ESOP borrows funds, which it uses to buy company shares or shares of existing owners. The company then makes tax-deductible contributions to the ESOP to repay the loan, meaning both principal and interest are deductible. There are limitations on the annual amount of contributions a company can make.

**Contribution Limits**

Companies can deduct up to 25% of covered eligible payroll to any and all defined contribution plans they sponsor (ESOPs, 401(k), profit sharing, money purchase, and stock bonus plans). However, based on a 2004 private letter ruling, in a leveraged C corporation ESOP, contributions used to repay the principal on an ESOP loan are subject to a separate 25% limitation, plus interest on the ESOP loan. (A cautionary note: private letter rulings apply only to the taxpayers who request them and may not be used as precedent; however, many authorities believe the IRS will continue interpreting the law in this way.)

Covered payroll is defined as the pay of all the participants in the plan up to compensation of $200,000 individually in 2002 dollars, to be indexed by inflation, rounded to $5,000 increments. For 2009 the annual compensation limit is $245,000 per participant.

In C corporations, the interest on payments on an ESOP loan does not count towards the 25% limit; in S corporations, it does.

**Dividends/Distributions**

Companies can deduct dividends paid on ESOP held stock in three ways:

- First, dividends may be paid in cash to ESOP participants, either directly or as payments to the ESOP that are distributed to participants within 90 days after the close of the plan year
- Second, dividends may be applied to loan payments in a leveraged ESOP transaction
- Third, effective for plan years after December 31, 2001, dividends voluntarily reinvested in company stock in the ESOP by employees are deductible to the company

Dividend deductions are not subject to the 25% limits for ESOP contributions. To be deductible, dividends must be "reasonable"; additionally, they are not deducted from income when computing the alternative minimum tax. Although not deductible from income in the case of S corporations, distributions can be used to repay ESOP debt.

When dividends are directly paid to plan participants on the stock allocated to their ESOP accounts, such dividends are fully taxable, although they are exempt from income tax withholding and are not subject to the 10% excise tax that applies to early distributions.
Create an Additional Employee Benefit

A company can issue new shares to an ESOP, deducting their value (for up to 25% of covered pay) from taxable income. Or a company can contribute cash, buying shares from existing public or private owners. In public companies, which account for about 5% of the plans and about 40% of the plan participants, ESOPs are often used in conjunction with employee savings plans. Rather than matching employee savings with cash, the company will match them with stock from an ESOP, often at a higher matching level.

Numerous studies demonstrate that ESOP owned companies outperform their peers and enjoy better results compared to what would have been expected absent the ESOP. One of the keys to realizing these benefits are by establishing a process to communicate how the ESOP works to employees and to get them more involved as owners.

What Are the Alternatives?

Depending on the state of the economy, your industry and the size of your company, it may be difficult or impossible to find another buyer willing to offer a reasonable price. The ESOP can offer a reasonable exit strategy to the owner in this type of situation.

If there is an outside buyer, the seller may find that the tax advantages available to him in selling to an ESOP nearly offset any premium that would be paid by the outside party. Furthermore, the seller can have a continuing employment relationship if the seller wants to stay with the company, not to mention the other benefits of an ESOP already discussed.

All of this can be done at a fraction of the cost of a sale to a third party using a traditional investment banker.

S Corporation ESOPs

Compared to C corporations, S corporations owned by an ESOP have unique rules regarding contribution limits, distributions, and there are special anti-abuse rules that must be adhered to or the company faces significant penalties. The anti-abuse rules were designed to discourage the use of ESOPs in S corporations for the benefit of just a few employees. Sellers cannot defer gains made from the sale of stock to an ESOP under section 1042.

S corporations do not pay tax at the corporate level. Rather, owners of an S corporation pay taxes on their proportionate share of the company’s earnings at their individual rates. The company usually makes distributions to the shareholders to cover their tax liability.

Profits attributable to the ESOP's ownership of stock in an S corporation are not subject to federal income tax; most states follow this provision in their own tax laws. This creates an extremely attractive benefit for 100% owned ESOP S corporations – they pay no federal income tax. Some states require the payment of state income tax.

If the company is already an S corporation and seller wants to elect a section 1042 roll over in an ESOP transaction, companies can revoke their S status, sell to the ESOP, then reconvert to S status five years later (S corporation law prohibits earlier reconversion). During the five-year period, payments on the loan used to buy out an owner often eliminate or substantially reduce corporate taxes in any event.

S corporations can only have one class of stock and no more than 100 owners. As a result, S corporations typically require departing employees to take their benefits in the form of cash rather than stock, thus avoiding the potential disqualification that could occur if an employee put the stock into an IRA, which is not a qualified S corporation owner, or exceeding the 100 shareholder limitation.
What Does the Seller Receive?

Fair Market Value
By definition, the ESOP can only pay “fair market value.” Fair market value is defined by Revenue Ruling 59-60, ERISA § 3(18) (B) and Proposed U.S. Department of Labor Regulation Section 2510.3-18 (b)(2), as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. The hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well-informed about the asset and the market for that asset. The asset is valued on a stand-alone basis.

The price paid by the ESOP differs from “investment value” which is typically paid in a merger or acquisition. Investment value is defined in the American Society of Appraisers’ Business Valuation Glossary as the value to a particular investor based on individual investment requirements and expectations. Investment value differs from fair market value, for various reasons, including:

- Economies of scale available with the buyer’s operations
- Synergies available with the buyer’s operations
- Differences in future earnings estimates
- Differences in perceived risk
- Differences in tax status

Tax Deferral of Capital Gains
Under section 1042 of the Internal Revenue Code, an owner of a privately held C corporation can defer capital gains taxes on stock he or she sells to an ESOP if (1) the ESOP owns 30% or more of the total value of all outstanding common stock; and (2) the seller reinvests the sale proceeds into qualified replacement property (stocks or bonds of domestic operating companies) during the period from three months before to twelve months after the sale. Two or more owners may combine their sales to meet the 30% requirement if the sales are part of a single, integrated transaction.

The money "rolled over" into qualified replacement property need not be the actual proceeds from the sale, but rather can be an equivalent amount of money from another source. Any or all of the proceeds can be rolled over; the seller will simply be taxed on the balance. As the owner sells the qualified replacement property he or she is taxed; however, sellers using the section 1042 rollover often avoid taxation completely by retaining the replacement property until death, at which time the property in the estate gets a stepped-up basis.

Several additional noteworthy points regarding section 1042 roll over:

- None of the shares sold to the ESOP in a transaction to which section 1042 applies may be allocated to ESOP accounts of the seller, certain relatives of the seller, non-selling shareholders holding more than 25% of company stock, or family members of the more-than-25% shareholders if they own stock by attribution (e.g., spouses).
- This restriction does not apply to ESOP stock not purchased in the 1042 rollover transaction.
- Where an outside lender is involved, it is common in 1042 transactions for sellers to facilitate the sale by pledging part or all of their replacement property as collateral for the loan.
- The 1042 rollover is not available upon the sale of S corporation stock to an ESOP.
- The selling shareholder(s) must have held the stock for at least three years before the sale to the ESOP and cannot have received the stock through exercising stock options or certain employee stock arrangements under Section 83 of the Internal Revenue Code.
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- If the ESOP disposes of the shares within three years after the sale, the employer generally must pay a 10% excise tax on the proceeds from the disposition.

**Financing the Transaction**

In leveraged ESOP transactions (borrowed funds are used to acquire stock), arrangements must be made for securing the financing needed to complete the transaction. Lending institutions are becoming increasingly familiar with how ESOP loans are structured.

The lender may also be the seller (“seller financed”). Many transactions are a combination of bank and seller financing. If outside lenders are involved, they often demand the seller to provide some collateral: often in the form of pledging the shares sold to the ESOP or even a personal guaranty depending on the relationship the company and the seller have with the lender.

In the event of a partial or complete seller financed ESOP transaction, the owner receives a reasonable level of interest income on the notional amount of the transaction as the seller note is repaid. One of the benefits of seller financing is that former owner can often be more flexible on terms of the seller note. The owner will often remain involved with the company (as an employee or in some other capacity) until the seller note is repaid.

**Legacy**

One of the primary ways a strategic buyer realizes above average returns on an acquisition is by reducing expenses in the target company in order to increase earnings. This can result in the elimination of entire divisions and a significant reduction in employees.

Owners sometimes have a desire to share the wealth their valued employees have helped create. In addition to the financial benefits ESOPs offer, leaving a legacy can be a motivating factor in implementing an ESOP.